INSTITUTE OF MANAGEMENT

J. K .LAKSHMIPAT UNIVERSITY

JAIPUR (RAJ.)

Research Proposal

On

"Impact of "Buy back of shares" on Share Prices of the Companies Listed on NSE& BSE"

Faculty Guide:

Dr. Biraj K Mohanty

Submitted By:

Rabindra Kr. Singh

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Introduction:

Share capital represents owner's contribution in the business. It is most significant part of a company.The share capital of a company has to be subscribed by one or more persons. After the share of a company has been allotted to the subscriber, the subscriber has no right over the money gone as proceeds of the shares subscribed. All that the shareholder has is the right to vote at the genral meeting of the company or the right to receive dividend or right to such other benefits which may have been prescribed.The only option left with the shareholder in order to realise the price of the share is to transfer the share to some other person.

But there are certain provisions in the Companies Act which allow the shareholders to sell their shares directly to the company and such provisons are termed as "buy back of shares". Buy back of shares can be understood as the process by which a company buys its share back from its shareholder or a resort a shareholder can take in order to sell the share back to the company.Its an option available to shareholder to exit from the company business.

History:

Prior to the ammendment of the 1999 of the companies act there was no way a company could buy its shares back from the shareholders without a prior sanction of the court (except for the preferential shares).The laws as to the buying of its share by the companies were very stringent. Some of the ways by which a company could buy its share back were as follows:

a. Reduction of share capital as given in sections 100 to 104.
b. Redemption of redeemable preferential shares under section 80.
c. Purchase of shares under an order of the court for scheme of arrangement under section 391 in compiance with provision of sections 100 to 104.
d. Purchase of shares of minority shareholders under the order of the company law board under section 402(b).

Though there were ways by which a company could buy its shares back from the shareholders but it could not be done without the sanction of the court. It was very complex and time taking process; hence the need of simple ways of buying its shares back by the company is felt so as to protect the rights of creditors and shareholders.The need was fullfilled when government introduced company's amendment Act 1999.Section 77A, 77AA and 77B were inserted in the companies act by this amendment. As a result of this amendment many companies started exploring this route to gain shareholders confidence and market capitalization.

Conditions For a buy back :

Sub clause (2) of section 77A enshrines the conditions for a buy back, which are as follows:

a. It should be authorised by the articles of association of the company
b. A special resolution has been passed at the general meeting of the company authorising the buy back.
   If the buy back is or less than 10% of the total paid upequity share capital, a resolution at the general meeting is not needed to be passed rather a simple board resolution is enough.Provided that no offer of buy back shall be made within three sixty five days reckoned from the date of proceeding offer of buy back.
c. The buy back is or less than 25 %of the total paid up equity share/capital and free reserves
d. The ratio of debt owned by the company is not more than twice the capital and its free resereves after such buy back.
e. All the shares or other specified securities for buy back are fully paid up.
f. The buy back shares or other specified securities listed on any recognised stock exchange board of India in this behalf
g. The buy back in respect of shares and other specified securities other than those specified in the aforesaid clause is in accordance with the guidelines specified.

Recently Government allowed to PSU companies to buy back their own shares from government as part of their strategy to raise a substantial amount of fund to bridge the widening fiscal deficit.

Reason for buy back:

Following are possible reason for which companies go for buy back of their own shares.

A) To return surplus cash to shareholders:

When a firm doesn't have any profitable opportunity then, many companies try to reward their share price by returning them cash for share. Its one form of distributing the profit similar to dividend.

B) To increase the underlying shares value:

Some time companys undertake buy back decision to uplift the moral of the share holders. Company displays their confidence and long term vision by paying high premium for their own share. It attracts new investor and helps the desperate shareholders to exit at a premium. The buy back of share by company signal undervaluation of the share, which attracts new investor. This helps in controling the falling share prices.

C) To achieve or maintain a target capital structure:

Companies often undertake buy back decision to change its capital structure. Company buy back its share to reduce weighted average cost by replacing costly equity capital with cheaper and tax deuctable debt.This strategy allows the company to actively manage its capital and to improve performanc measures. Reduced share capital results into increased earning per share and price earning ratio.

D) To replenish the pool of shares available for employee:

Company often undetake buyback to reduce the dilution caused by company share option plans. Such plans have become an increasingly large part of company's compensation plans worldwide. From time to time companies buyback share avoid excessive dilution that may occur as more and more options are granted and later exercised

F) To prevent or inhibit unwelcome take –over bids:

The buyback regulation provides a fair chance to the incumbent management to protect their turf in case of a hostile takeover. The takeover code allows the company to offer a buyback even after a hostile bid has been made. A buyback at higher price raises the market prices and make the take over expensive for the raider.

Process of buyback:

Under the buyback regulation a company can buyback its shares under following route:

1. Fixed price Tender offer: This is very powerful to implement a value creating buyback. A company may approach shareholders with a formal tender offer, whereby they have the option to submit (or tender) a potion or all share within a certain period (20-300 days period) at a preset (as mentioned in the public announcment required by regulation), generally at premium (typically between 15% and 20% above the market price). Tender offer is preffered when the buyback is large.If the shareholders tender more shares than the specified, the company has descretion to purchase the whole or a part of the excess shares or company may accept the share on a pro-rata basis. On other hand, if the it is undersubscribed, the company may either accept whatever is tenderd or extend the time limit. It provides equal opportunity to all shareholders to participate in the buyback process.

2. Open Market buy back: The second option available is to buy shares from open market through brokers over a long period where the maximum buy price is immaterial, as opposed to tender offer route. Here company announces maximum buy price and minimum buy price buyback price, while the actual price is market determined. This option companys generally uses when the size of buy back is relatively small. The company's prime objective here is not to manipulate the price but to distribut the excess cash to shareholders instead of dividend.

Review of literature:

Share buy-back are similar to dividends because both are used to distribute cash back to shareholders and both are considered as a positive signals. In past literatures there are several reasons for buy-back such as signaling hypothesis or under-valuation hypothesis, free cash flow hypothesis, defensive strategy to avoid takeover adjusting optimal leverage ratio, substituting for dividends and preventing dilution associated with the exercise of managers' stock option. This issue is purely an empirical issue to discuss. A brief overview of the past literature has been given.

Foreign Studies Related to Buy-Back of Shares:

Masulis (1980) has observed that there will be no announcement effect on price around the even day. They have used some alternative methods (apart from event study) to test for the value effect of share buy-back. Vermaelen (1981) found that a statistically significant CAR of –7% in the 60 days preceding the repurchase announcement precedes open market repurchases. He infact found that repurchase are accompanied by positive abnormal returns.

Dann (1981) investigated that share buy-back led to shareholders experiencing positive share returns of approximately 15 percent and that these positive returns were mostly permanent in that share prices did not return to their pre-buy back date levels

David and Garrison (1989) examined the impact of common stock repurchasing firms common stock returns. They have many other studies undertaken in the past on the usage of event study methodology to measure the likely impact of buyback announcements on share prices and their returns. however, this was a first study undertaken in Indian scenario.

Dann, Masulis and Mayers (1991) have found abnormally high earnings by the companies follow buy-backs, according to this study managers announce buy-backs when they believe the shares of their company are undervalued.
Persons (1994) found that fixed price repurchases are more effective signal of under- valuation and Dutch auction repurchases are more effective takeover deterrents. He empirically tested the firms making fixed price offers and Dutch auctions between the years 1980-92 and observed that fixed price offers increase the market value of the firm because they signal high firm value and Dutch auctions are better takeover deterrents.

Harris and Ramsay (1995) examined share buy-back for the period 1989-93 in Australia. They found that although the announcement of share buy-backs is associated with a positive abnormal price performance, the effect is not statisitcally significant.

Pavabutr and Sirodom (2008) examined the impact of stock splits on stock price and various aspects of liquidity using daily and intra-day data from the Stock Exchange of Thailand between 2002- 2004. Their paper finds evidence that stock splits can have favorable impact on stock price through reduction of trade frictions such as bid-ask spreads and price impact measures

Andoain, Bacon, and Frank (2009) tested whether the investor can make an above normal return by relying on public information impounded in a stock split announcement. Results suggested that the firms' public stock split announcements did not affect stock price on the announcement day.

Indian Studies Related to Buy-Back:

Chowdhry and Nanda (1994) explain that even when management's motivation for undertaking repurchases is to disgorge free cash flow and not to signal under-valuation; undervalued firms are more likely to choose repurchases over dividends. Thus, the free Cash flow hypothesis is entirely consistent with evidence showing a negative relationship between repurchases and prior stock price changes (Stephens and Weisbach, 1996).
Saha (1999) reviewed buy-back policy announced by the government. buy back of shares is a good financial strategy and have so many advantages but also suffers from some disadvantages.

He suggested that this strategy should be used after analyzing the financial position of a firm.

Puri (2001) in a survey of the 14 buy-backs that have been announced in India till January 15, 2001 finds a different result. However, she reports in the investor's guide on Febuary 19,2001 that only 2 out of 13 companies (MICO did it twice) which have come up with buy back offers have been successful in having the desired effect—achieving superior share performance and returns for the shareholders. This result is quite surprising because it goes against the commonly held belief that buy-back of shares is accompanied by an increase in the share price.

Mohanty (2002) studied 13 buy back announcement during the year 1999-2001 and found that buy-backs have not been able to increase the shareholders wealth perceptibly as argued by financial economists. He also found the evidence of insider trading before the share buy-back is announced. In concluding remarks temporary increase in the stock prices in the period surrounding the buy back announcement has been observed.

Gaps in literature:

There are many literatures available on "buy back of shares" but most study is on foreign countries, only little study has been conducted in Indian context. In India "buy back of share" is relatively new phenomenon. It becomes more popular after amendement of company Act1956 in 1999. Number of company going for buy back of share have gone up significantly in last few years. It is also observed the impact of buy back is different for different set of company. Only little company is succesful in achieving their desired goal through buy back. The study will be to identify the motivating factor for "buy back of shares"for the company. Is it really good for shareholders or its just one means of window dressing different financial number.Who benefits from buy back of shares?How this decision is related to share prices?How to make buy back decision successful both in terms shareholders wealth creation and growth of the company? Indian capital market has also evolved over a period of time; foreign participation and private player have strengthend the market forces. In these circumstances, relevence of "buy back of share decision" need to be studied? Long term impacts of buy back decision on share prices also need to be studied.

Objective of the study:

1. To study the impact of "buy back anouncement" on the "share price" of the concerened company with respect to certain factors such as the "rate of diffusion of announcement" and size of the company or the industry

2. To study the impact of buy back of shares on the company valuation and shareholder's wealth.

Hypothesis:

Ho_1: There is no significant difference between share prices before and after buyback for Mid-cap organisations

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Ho_2: There is no significant difference between share prices before and after buyback for Large-cap organisations

Ha_2: The is a significant difference between share prices before and after buyback for Large-cap organisations

Ho3: There is no significant difference in the rate of diffusion of buy back announcement between Mid-cap and Large-cap organisations.

Statement of purpose:

Buy back in India gianed popularity after amendement of company Act 1999. After this amendment many company use this route to achieve various corporate goals. But the success rate of buyback is not very high; impact of buyback decision on investor's sentiment is also not uniform. Also who really Gaines from this decision is not clearly defined.so there is needed to understand this phenomenon in detail. Which kind of company can benefit from the buy back decision? Is it just way to window dress the different financial number? Can this decision help to uplift the moral of the shareholder? Attract new investor. What determine the success and failure of buyback decision?

Also it would try to understand the motivating factors for buy back. Many a times company spend heavy cash for buyback but they fail to support the falling share price.At the same time company market capitalization also falls,hence existing shareholders lose their wealth. It is observed that small size companies find it difficult to attract shareholders attention to buy back offer. The study will be to understand the impact of buy back decision on companies of different size and different industry.Try to understand relation between price movement and size of companies.

Research Methodology:

a) Study: Research is causal in nature.

b) Sample:

Population: The population will consist of companies which have gone for buy back offer in last five year.

Sample: 20% of the total population from various segments of the population by using stratefied random sampling technique.

c) Data collection:

Primary Data:

Interview from few top corporate two understand their motivation for buy back.

Secondary Data:

NSE database

d) Statistical tests: Pair sample t-test and Pearson's co-relation test will be used.

Scope of the study:

The study has been confined to all the companies listed in Indian stock exchange specially NSE, and has gone for buy back of shares in the last five years.

Significance of the study:

Share buy back by Indian companies is gaining popularity. Companies as well as capital market can be thus rejuvenated by resorting to this new tool of financial re-engineering. The decisions whether are all that atractive to company and its shareholders depend upon many factors, which may be unique to each case. Due consideration has been given to each factor before a final decision is made. This study will help in understanding all factors. This study will help in understanding regulatory requirement of the buy back decision as many a time company use buy back decision to manipulate the price. How to make buyback decision more efficient and transparent.

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LAY OUT OF THE THESIS

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References